LEGISLATION

The Federal Revenue Act of 1936

On March 3, 1936, President Roosevelt in his message to Congress stated: "I invite your attention . . . to a form of tax which would accomplish an important tax reform, remove two major inequalities in our tax system, and stop 'leaks' in present surtaxes." [1] On June 22, 1936, the President approved the Act [2] which was the direct result of his message, and thereby put into effect a major change in the taxation of corporate income. In former years, corporations had been subjected to either a flat tax or a slightly graduated tax upon net income,[3] without regard being had to the subsequent use made of that income. While the new Act continues the graduated tax upon net income with only small variations in gradations,[4] its most important feature consists of a steeply graduated surtax upon the undistributed profits of corporations. This surtax rises to a peak of twenty-seven per cent when the corporation retains more than sixty per cent of its adjusted net income.[5]

The Purpose of the Act

The major purpose of the Act is to prevent tax avoidance by those whose income is subject to the higher individual surtaxes.[6] Previously, many taxpayers found it profitable to allow their income to accumulate in the form of corporate reserves during the years when their income from other sources was high enough to bring them within the upper tax brackets. The money left in the corporation was never subjected to more than a fifteen per cent tax. Thereafter, either when the surtax on individuals was lowered,[7] or the individual's income for any one

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1. H. R. Doc. No. 1418, 74th Cong., 2d Sess. (1936) 2.

2. Pub. L. No. 740, 74th Cong., 2d Sess. (June 22, 1936).

3. The last tax prior to the present Act ran from 12½% on net incomes of $2000 to 15% on incomes in excess of $40,000. This was included in the 1935 amendment [49 STAT. 1015 (1935), 26 U. S. C. A. § 13 (Supp. 1935)] to the REVENUE ACT OF 1934. 48 STAT. 686 (1934), 26 U. S. C. A. § 13 (Supp. 1935). This Act of 1934 had imposed a flat rate of 13¾% on the net income of corporations. The same was true of the REVENUE ACT OF 1932 (47 STAT. 177).

4. See *supra* note 2.

5. Section 14.

6. President Roosevelt, Message to Congress, cited *supra* note 1, at p. 3: "The accumulation of surplus in corporations controlled by taxpayers with large incomes is encouraged by the present freedom of undistributed corporate income from surtaxes. Since stockholders are the beneficial owners of both distributed and undistributed corporate income, the aim, as a matter of fundamental equity, should be to seek equality of tax burden on all corporate income whether distributed or withheld from the beneficial owners. As the law now stands our corporate taxes dip too deeply into the shares of corporate earnings going to stockholders who need the disbursement of dividends, while the shareholders who can afford to leave earnings undistributed escape current surtaxes altogether." H. R. REP. No. 2475, 74th Cong., 2d Sess. (1936) 3; see *Hearings before Committee on Ways and Means on H. R. 12395*, 74th Cong., 2d Sess. (1936) 800; *Hearings before Committee on Finance on H. R. 12395*, 74th Cong., 2d Sess. (1936) 22.

7. After the World War the surtax on individuals was rather high—the top bracket being 65%. 40 STAT. 1064 (1919). The Republican Party came into power with President Harding, who took office in March, 1921, and began to lower the top brackets. In the Act passed in the fall of the inaugural year the 65% bracket was lowered to 50%. 42

year decreased so that he was no longer within the higher income brackets, he would draw on these "incorporated pocketbooks".[8] Thus, many dollars were escaping the surtax mill. The federal government has attempted for many years, by penalty taxation of unreasonable accumulations of corporate reserves, to prevent this means of tax avoidance. This method, however, has been unsuccessful.[9] Under the present Act, manipulation of the payments of corporate dividends is rendered less likely and less effective because made less profitable.

The Act is intended also to remove certain inequities present under the former tax laws. The feeling had long been current that there was too great a partiality in taxation in favor of the corporate form of business, and against the individual.[10] A corporation could expand without limit, and yet be required to pay only a fifteen per cent income tax,[11] but if an individual's income extended beyond a hundred thousand dollars he paid at least a fifty-eight per cent tax on all income over that amount.[12] Under these conditions any person whose income totalled more than $30,000 (the sum at which the taxation of individuals and corporations is equal) naturally sought to carry on his business in a corporate form, in order that the resultant corporate income, provided there were no dividends, should not be subject to the tax of twenty per cent or greater which would be levied on individual income. Those antagonistic to the Act denied the existence of inequities under the previous tax acts on the ground that any individual could incorporate if he so desired.[13] The proponents of the Act realizing that there are many forms of activity that cannot be incorporated, such as law, medicine, etc., believed that by taxing the undistributed portion of the net income of corporations they were destroying the pre-existing differences in the taxation of corporate and non-corporate businesses.

The Act is further aimed at another inequality: the differences in the taxation of large-income and small-income shareholders caused by the imposition of

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STAT. 237. See a comment upon this, *Hearings before Committee on Ways and Means, supra* note 6, at p. 429. After Harding's death on August 2, 1923, the Coolidge Administration continued to lower the high surtaxes. In the 1924 Act there was another 10% decrease. 43 STAT. 267. Two years later this was lowered to 20% (44 STAT. 23) and continued at that figure in the Act of 1928. 45 STAT. 797. In 1932, the emergency created by the crash of '29 and the consequent depression forced the administration to raise the surtax to 55%. 47 STAT. 177.

8. See Jackson, *The Proposed Revision of Corporation Taxes*, N. Y. Times, March 19, 1936, p. 21, col. 1.

9. The first attempt was a penalty tax upon the stockholders of corporations that accumulated surpluses to avoid the individual taxes. 38 STAT. 166 (1913). This was strengthened and continued in the succeeding acts but did not accomplish what it set out to do. See President's Message, cited *supra* note 1, at p. 3; H. R. REP. No. 2475, *supra* note 6, at p. 5; *Hearings before the Committee on Ways and Means, supra* note 6, at p. 776; Legis. (1933) 7 ST. JOHN'S L. REV. 361.

10. H. R. REP. No. 2475, *supra* note 6. "Now, what we are seeking to do here is to subject all income, both of corporations and individuals, to practically the same basis for tax purposes." *Hearings before Committee on Ways and Means, supra* note 6, at p. 321; see also *id.*, at 341. *Cf.* REP. COMM. TAX & PUB. EXPENDITURES, PHILA. CHAMBER OF COMMERCE (April, 1936) 5.

11. This refers to the 1935 amendment [49 STAT. 1015, 26 U. S. C. A. § 13 (Supp. 1935)]; formerly the rate was even lower. See *supra* note 3.

12. 49 STAT. 1014 (1935), 26 U. S. C. A. § 12 (Supp. 1935).

13. *Hearings before Committee on Finance, supra* note 6, at p. 433; *Hearings before Committee on Ways and Means, supra* note 6, at p. 806.

flat rates on corporations.[14] Whether or not a corporation made a distribution to its shareholders, it paid a tax of no more than fifteen per cent on its earnings; the large-income and small-income shareholders, therefore, each bore the same percentage of tax on their proportional holdings. The Act may do much to remedy this disparity by bringing about a greater distribution of earnings. But if the Act does not produce this result, it will not only leave extant the inequalities between large-income and small-income shareholders but will actually enhance them. And although in the great majority of cases the Act should succeed, there are situations where it may fail.[15] For example, assume a hypothetical corporation that earns one million dollars in 1936. The controlling stockholder owns fifty per cent of the shares. The remaining shares are divided among one thousand other shareholders. The normal tax on such a corporation is $148,840; the adjusted net income, $851,160. Assume further that the controlling stockholder is self-sufficient from other sources so that he is free to permit his portion of the corporate earnings to accumulate in the corporation if he finds that course most profitable to him. If the entire earnings are distributed in the form of dividends, he will receive $425,580. The normal tax of four per cent on this amount is $17,023.20 and the surtax is $235,394.40, making a total of $252,417.60 or slightly over fifty-nine and one-half per cent of his share of the corporate earnings. If there are no dividends, his tax liability, disregarding the corporate entity, is much less. In that case, the corporation will have an adjusted net income and an undistributed net income of $851,160. The surtax on this amount is $174,487.79. In other words, his $425,580 would now bear a tax of $87,243.90, or twenty and one-half per cent, a saving of almost forty per cent,[16] subject, of course, to the eventual individual tax when that income is realized by him.

The interest of the other shareholders in the corporation, assuming that they are in the normal and not surtax brackets, lies primarily in a distribution of dividends. If there is a distribution, these shareholders will pay a four per cent normal tax and no more; if all the earnings are retained by the corporation, their proportion will be subjected to a twenty and one-half per cent surtax. It is in such a factual set-up that the purpose of the Act may not be effectuated, for the controlling shareholder would undoubtedly do his utmost to prevent a corporate distribution. Fortunately, however, such a corporate make-up is rare.

There is little doubt that the motivating desire of the government and the taxing authorities was to tax each individual on a basis of his profits whether

14. One of "the major purposes of the change in the method of taxing corporate incomes . . . [is] (3) to remove the inequity as between large and small shareholders resulting from the present flat corporate rates." H. R. REP. No. 2475, *supra* note 6. It was also expressed that the idea of the new tax was to tax in proportion to the ability to pay and let the government occupy a neutral position and not discriminate among its taxpayers. *Hearings before the Committee on Ways and Means, supra* note 6, at p. 53.

There is some feeling that the "chief aim of the new law is, of course, to force declarations of dividends, (and) collect high surtaxes from the rich." TIME (June 29, 1936) 12. See also, R. G. Blakey and G. C. Blakey, *The Revenue Act of 1936* (1936) 26 AM. EC. REV. 466, 472.

It was also stated that the Act would avoid the inequality caused by the fact that shareholders in a corporation that did not distribute its earnings under the former acts were in effect reinvesting their earnings without paying any tax. On the other hand, stockholders of corporations distributing their earnings had to pay a tax before reinvestment. It was felt that the undistributed profits tax evened up this inequality in cost of reinvestment. 80 CONG. REC. 6174 (1936).

15. See *Editorial*, N. Y. Times, May 4, 1936, p. 18, col. 1.

16. See SEN. REP. No. 2156, Part 2, 74th Cong., 2d Sess. (1936) 6.

distributed to him or left in a corporation.[17] If such a tax could be directly levied, that is, if each individual had to include in his income tax returns his proportionate amount of the income of any corporation of which he was part owner, the new corporate surtax would be unnecessary.[18] The controlling shareholder would include in his income tax returns the $425,580 whether that amount was distributed to him or not. Likewise, each of the other shareholders would include that portion of $425,580 which represented his interest in the corporation's earnings. However, since the Supreme Court has held unconstitutional the taxation of common share dividends received by a common shareholder on the ground that the recipient realized no income,[19] then *a fortiori* it would seem that a shareholder may not be taxed on undistributed income where there has not even been the formality of a stock dividend declaration.[20] Much of the present Act has its origin in the attempt to circumvent this constitutional restriction.

Operation of the Act

The provisions dealing with the tax on individuals remain much the same except that dividends, previously subjected only to individual surtax,[21] are now subjected to the normal tax as well.[22] The importance of this change is increased by the fact that the Act will result in a greater release of dividends.

Taxes upon corporate income have been radically revised. They now exist in two forms: (1) the normal tax on corporations,[23] and (2) the surtax on that portion of net income which the corporation does not distribute.[24] The normal tax is similar to that of the 1935 revision of the Revenue Act, but contains steeper gradations. Its basis is the sum found by subtracting from the net income the total of the following: (1) interest on obligations of the United States and its instrumentalities, and (2) eighty-five per cent of the amount received as divi-

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17. Representative Lewis: "I do not know that it is fully understood by the public that this roundabout device of compelling the distribution of the real income of the corporation to its shareholders, so that the shareholders may be called upon to pay taxes upon their income, is due to a decision of a divided court. Some years ago the Supreme Court in a sharp decision determined that we could not . . . require the shareholder to pay his tax on his income just the same whether his company had refused to distribute it or not.

"Now, if that decision of the Court should be reversed, what we are doing here, or attempting to do in order to reach the taxpayer here, the method of our attempt, would not be necessary. Not ours the fault of all this clumsiness and indirection of approach to a necessary public object." *Hearing before the Committee on Ways and Means, supra* note 6, at p. 193. In a letter to the writers of this legislation, Representative Lewis affirmed what is rather clear, namely that he was referring to the case of Eisner v. Macomber, 252 U. S. 189 (1921).

18. See *supra* note 17.

19. Eisner v. Macomber, 252 U. S. 189 (1921).

20. There is increasing theoretical opinion that a tax upon stock dividends is an indirect tax and therefore not within the prohibition of Art. I, § 2, cl. 3, and § 9, cl. 4, compelling Congress to levy a direct tax proportionately among the several states. See Sphahr, *The Supreme Court on the Incidence and Effects of Taxation* (1925) SMITH COLLEGE STUDIES IN HISTORY 129, 130; Evans, *A Constitutional Problem in Federal Income Taxation* (1935) 7 RKY. MT. L. REV. 85, 97-108; Powell, *Stock Dividends, Direct Taxes and the Sixteenth Amendment* (1920) 20 COL. L. REV. 536, 539-40; Magill, *Realization of Income Through Corporate Distributions* (1936) 36 COL. L. REV. 519, 526, n. 83. However, although it might well be that the Court would refuse to overrule *Eisner v. Macomber*, yet if a tax upon the privilege of accumulating a surplus in a corporation were levied it is possible that the Court might uphold it as an indirect tax.

21. 48 STAT. 692 (1934), 26 U. S. C. A. § 25 (1935).

22. Section 25 (a) (1) of the 1934 Act is omitted in the 1936 Act.

23. Section 13 (b).

24. Section 14 (b).

dends from a domestic corporation subject to taxation under the Act.[25] This sum is defined as the normal tax net income, and is taxed as follows:

First $2,000	8 per cent
$2,000 to $15,000	11 per cent
$15,000 to $40,000	13 per cent
The amount over $40,000..................	15 per cent [26]

The surtax upon that portion of the net income which the corporation does not distribute provides the novel feature of the Act. In order to find the amount of this tax, two figures must be determined: (1) The adjusted net income—obtained by subtracting from the net income the sum of the following: the normal tax paid and the interest upon obligations of the United States or its instrumentalities.[27] (2) The undistributed net income—obtained by determining the adjusted net income and subtracting from it the sum of the following: (a) distributed dividends which are taxable in the hands of the stockholder; (b) the amount which the corporation has contracted not to pay out in dividends *or* the amount which the corporation has contracted to set aside for the payment of debt.[28] Once these two figures are obtained, the surtax may be calculated as follows:

7% upon the first 10% of the adjusted net income which is undistributed;
12% upon the next 10% of the adjusted net income which is undistributed;
17% upon the next 20% of the adjusted net income which is undistributed;
22% upon the next 20% of the adjusted net income which is undistributed;
27% upon the remaining 40% of the adjusted net income which is undistributed.[29]

The amount taxed is always the undistributed net income; the adjusted net income is the yardstick determining the amount of the undistributed net income which is to be taxed at the various percentages. For example, if the undistributed net income is equal to fifteen per cent of the adjusted net income, there is a seven per cent tax on that part of the undistributed net income which is equal to ten per cent of the adjusted net income, and a twelve per cent tax on the remaining portion of the undistributed net income, since that portion comes within the second ten per cent of the adjusted net income.[30]

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25. Section 13 (a).

26. Section 13 (b).

27. Section 14 (a) (1).

28. Section 14 (a) (2). Of the two provisions, contracts restricting the payment of dividends and contracts providing for the disposition of profits for the year, the corporation can only take advantage of one, and will naturally choose the larger. Section 26 (c) (3).

29. Section 14 (b).

30. The following table can be be used to determine the undistributed profits tax and the cost in per cent terms of retaining any portion of the adjusted net income. To use the table, divide the undistributed net income by the adjusted net income. The quotient thus obtained is the percentage of the adjusted net income that the corporation is retaining. The corresponding figures in the second column state in percentage terms the amount of the adjusted net income that the corporation will have to pay as a surtax. The third column gives the cost in percentage terms of retaining the undistributed amount. To illustrate: If a corporation has an adjusted net income of $100,000 and distributes in dividends $20,000, and has no other credits, its undistributed net income is $80,000. In other words, it is retaining eighty per cent and that is the figure to be used in the first column. The second column gives the per cent of the adjusted net income that the corporation will have to pay as a surtax—15.10 per cent. This figure multiplied by the adjusted net income gives the amount of the surtax in dollars, in this instance, $15,000. The last column informs the corporation in percentage terms how much of the amount retained it is paying as a surtax. In other words, the corporation is re-

An important feature of the surtax is the provision whereby corporations receive credit, that is, an amount which they may subtract from the sum that they

taining $80,000 but must pay the federal government 18.875 per cent of that amount in order to do so. The result is that the corporation keeps $64,900 of the original $80,000.

The undistributed net income divided by the adjusted net income in percentage terms.	Percentage of the adjusted net income paid in taxes to retain that portion.	Percentage of the undistributed net income the corporation pays to retain that amount.
100%	20.50%	20.500%
99	20.23	20.434*
98	19.96	20.367*
97	19.69	20.298**
96	19.42	20.229*
95	19.15	20.157**
94	18.88	20.085*
93	18.61	20.010**
92	18.30	19.934**
91	18.07	19.857*
90	17.80	19.777**
89	17.53	19.696**
88	17.26	19.613**
87	16.99	19.528**
86	16.72	19.441**
85	16.45	19.352**
84	16.18	19.261**
83	15.91	19.168**
82	15.64	19.073*
81	15.37	18.975*
80	15.10	18.875
79	14.83	18.772*
78	14.56	18.666**
77	14.29	18.558*
76	14.02	18.447*
75	13.75	18.333*
74	13.48	18.216*
73	13.21	18.095**
72	12.94	17.972**
71	12.67	17.845*
70	12.40	17.714*
69	12.13	17.579**
68	11.86	17.441*
67	11.59	17.298**
66	11.32	17.151**
65	11.05	17.000
64	10.78	16.843**
63	10.51	16.682**
62	10.24	16.516*
61	9.97	16.345**
60	9.70	16.166**
59	9.48	16.067**
58	9.26	15.965**
57	9.04	15.859**
56	8.82	15.750
55	8.60	15.636*
54	8.38	15.518**
53	8.16	15.396*
52	7.94	15.269*
51	7.72	15.137*
50%	7.50%	15.000%
49	7.28	14.857*
48	7.06	14.708*
47	6.84	14.553*
46	6.62	14.391*
45	6.40	14.222*
44	6.18	14.045*
43	5.96	13.860*
42	5.74	13.666**
41	5.52	13.463*
40	5.30	13.25
39	5.13	13.153**
38	4.96	13.052**
37	4.79	12.945**
36	4.62	12.833*
35	4.45	12.714*
34	4.28	12.588*
33	4.11	12.454**
32	3.94	12.312**
31	3.77	12.161*
30	3.60	12.000
29	3.43	11.827**
28	3.26	11.642**
27	3.09	11.444*
26	2.92	11.230**
25	2.75	11.000
24	2.58	10.750
23	2.41	10.478*
22	2.24	10.181**
21	2.07	9.857*
20	1.90	9.500
19	1.78	9.368*
18	1.66	9.222*
17	1.54	9.058**
16	1.42	8.875
15	1.30	8.666**
14	1.18	8.428**
13	1.06	8.153**
12	.94	7.833*
11	.82	7.454**
10	.70	7.000
9	.63	7.000
8	.56	7.000
7	.49	7.000
6	.42	7.000
5	.35	7.000
4	.28	7.000
3	.21	7.000
2	.14	7.000
1	.07	7.000
0	.00	0.000

*Indicates that there is a remainder of less than .0005.
**Indicates that there is a remainder of more than .0005.
Absence of * indicates that there is no remainder.

would ordinarily use as the basis for calculating their undistributed profits tax, for (1) those amounts which cannot be distributed without violating a provision of a written contract executed prior to May 1, 1936,[31] *or* (depending on whichever is greater) [32] (2) that amount which, under a similar contract the corporation is either required to pay out in the discharge of debts or irrevocably to set aside for that purpose within the taxable year,[33] provided that the latter credit be limited to the amount actually paid or irrevocably set aside. Although these sections were made part of the Act for the purpose of ameliorating possible hardship, the Treasury Regulations bearing on the subject have practically destroyed all the equity contained therein. Thus, under the provision for contracts restricting payments of dividends, the Treasury Department has ruled that a charter of a corporation does not constitute a written contract within the meaning of the section.[34] It has been said that "a complete and final definition of the word 'contract' will perhaps never be reached. . . ." [35] However, without entering into a technical discussion of whether a charter of a corporation constitutes a contract in the orthodox sense, or constitutionally under the *Dartmouth College* case,[36] nevertheless, it does appear that a corporate charter is within the spirit of the section. It is probable that this regulation will not be upheld.

With regard to the provision concerning the allocating of profits for the purpose of repaying debts, the Treasury Regulations again have been very narrow. Contracts for the retirement of bonds or for the maintenance of sinking funds are not within the section.[37] But a contract requiring a corporation to set aside a portion of its earnings to retire mortgage bonds is within the section.[38] Such a distinction is unjustifiable and it would seem that on a basis of fairness both should be considered as proper deductible credits. It is obvious that the section was incorporated in the Act for the purpose of alleviating the inequity that would arise if a corporation that could not pay dividends were taxed at the same rate as a corporation which, after weighing the comparative values, decided to retain its income. However, under the Treasury Regulations many of the inequalities that the section was designed to prevent, will return.

Finally, there is a provision designed to lower the surtax on corporations of small income. There are two interpretations of the meaning of this section, which reads:

> "If the adjusted net income is less than $50,000, there shall be allowed a specific credit equal to the portion of the undistributed net income which is in excess of 10 per centum of the adjusted net income and not in excess of $5,000, such credit to be applied as provided in paragraph (2).
>
> (2) Application of specific credit.—If the corporation is entitled to a specific credit, the tax shall be equal to the sum of the following:

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31. Section 26 (c) (1).

32. Section 26 (c) (3).

33. Section 26 (c) (2).

34. U. S. Treas. Reg. 4674, Art. 26-3 (a).

35. United Transp. & Lighterage Co. v. New York & Baltimore Transp. Line, 180 Fed. 902, 904 (S. D. N. Y. 1910), *aff'd*, 185 Fed. 386 (C. C. A. 2d, 1911).

36. Dartmouth College v. Woodward, 4 Wheat. 517 (U. S. 1819); see BLACK, CONSTITUTIONAL LAW (4th ed. 1927) § 280.

37. U. S. Treas. Reg. 4674, Art. 26-3 (c): "A corporation having outstanding bonds is not entitled to a credit under a provision merely requiring it, for example, (1) to retire annually a certain percentage or amount of such bonds, (2) to maintain a sinking fund sufficient to retire all or a certain percentage of such bonds by maturity. . . ."

38. U. S. Treas. Reg. 4674, Art. 26-3 (b), Example (1).

(A) A tax computed under subsection (b) [the ordinary surtax on undistributed profits] upon the amount of the undistributed net income reduced by the amount of the specific credit, plus

(B) 7 per centum of the amount of the specific credit." [39]

It would seem that the reasonable interpretation of the section would require that the specific credit be calculated in the following manner: the amount equal to ten per cent of the adjusted net income should be subtracted from the undistributed net income, and the remainder should be the specific credit unless that remainder were in excess of $5,000, in which case the specific credit would be $5,000. In other words, the corporation is given as a credit that "portion of the undistributed net income" which remains after subtracting from it ten per cent of the adjusted net income, with the limitation, however, that the credit cannot be more than $5,000. Although this seems rather clear, the Treasury Regulations have interpreted the section as follows: "This specific credit is an amount equal to the excess of $5,000 or the total undistributed net income, whichever is less, over 10 per cent of the adjusted net income and is to be deducted from the undistributed net income before computing the surtax." [40] This means that under the Treasury Regulations the specific credit is either the undistributed net income or $5,000, whichever is less, minus ten per cent of the adjusted net income. Under this interpretation the specific credit can never be more than $4,500. Assuming a corporation with an adjusted net income of $40,000 and with no distribution or other credits, so that the undistributed net income is $40,000, and applying in turn the interpretation advanced above and the interpretation of the Treasury, we arrive at this result:

Following the words of the Act, the "portion of the undistributed net income which is in excess of 10 per centum of the adjusted net income" is $36,000. (This amount is obtained by taking ten per cent of the adjusted net income, $4,000, and subtracting it from the undistributed net income). However, since this amount ($36,000) is in excess of $5,000, the specific credit is equal to $5,000. But under the Treasury Regulations, since the "total undistributed net income" is more than $5,000, the specific credit is equal to $5,000, minus ten per cent of the adjusted net income ($5,000–$4,000) or $1,000. The total surtax, under the literal application of the Act would be $7,200; under the Treasury Regulations the surtax would be $8,000. The difference between the two interpretations here would be $800—the greatest it can be is $999.98.

39. Section 14 (c).

40. U. S. Treas. Reg. 4674, Art. 14-4. The only attempt to justify the interpretation which was subsequently adopted by the Treasury Department appears in C. C. H. Fed. Tax Serv. ¶ 5278. The theory there presented is: The phrase in § 14 (1) to the effect that the specific credit shall be "the portion of the undistributed net income which is in excess of 10 per centum of the adjusted net income and not in excess of $5000", is almost identical with the phrase repeated many times, except for changes in the numbers, in § 14 (b) to the effect that the surtax shall be a certain percentage of "the portion of the undistributed net income which is in excess of 10 per centum and not in excess of 20 per centum of the adjusted net income." Therefore, states C. C. H., "It is a reasonable conclusion that the first-quoted phrase should be interpreted in the same manner as the second, as to which second phrase there is no difference of opinion. The second phrase means the difference between 10 and 20 per cent. The first, therefore, should mean the difference between 10 per cent and $5000." But this apparently overlooks the fact that it is not the difference between 10 and 20 per cent of the adjusted net income which forms the basis of the surtax but rather the difference between 90% and 80%, since the excess of 10% is equal to 90% and the excess of 20% is equal to 80%. Therefore to arrive at the amount that will be taxed at a given percentage, the second figure must be subtracted from the first. C. C. H. obtains its result by committing two errors: (1) it fails to interpret that "10%" to mean 90%, and (2) it subtracts what it erroneously takes to be the first figure from the second figure, thus reversing the procedure used in section 14 (b) the section to which it is attempting to analogize.

The possibility of a corporation's reducing its tax liability by this not insignificant amount will probably bring about a challenge of the Treasury's interpretation.

Arguments

One of the major arguments of those who opposed the taxation of undistributed income was that it discriminated in favor of the old, established, and well-to-do corporation which had accumulated ample reserves over a long period of time,[41] and which could, therefore, dip into the accumulated surplus and make distributions without financial difficulty, thereby escaping the surtax imposed by Section 14; whereas a corporation that had barely managed to survive the depression and had no surplus would have to retain, in its rebuilding process, a large amount of the net income of each year upon which there would be the heavy surtax.[42] Were this objection valid, the ability to pay theory would be working in reverse, and the corporation with the greatest ability to pay would pay the least. To consider this argument fairly, it must be realized that under any system of law and as a matter of common sense, a corporation with ample reserves is always in a more advantageous position than a corporation which has no surplus or is in debt.[43] And the corporation that finds itself in the position where it must retain a portion of its net income can take advantage of Section 27 (e) and issue some form of taxable stock dividend. In this manner the corporation will be able to retain its income for purposes of rehabilitation and yet be free from the surtax. In the event that a corporation later feels that its capital structure is topheavy it can go through a statutory reduction of capital stock.[44] However, there may be instances where the issuance of share dividends will not be feasible or desirable.[45] The inequity caused by the Act in such a situation might have been lessened considerably by exemption of twenty-five per cent of the undistributed net income from the surtax.

Another point raised by those hostile to the Act was that discrimination would result because of varying provisions in the corporation laws of the several states.[46] That the Act would favor corporations situated in a state whose laws permit dividends to be paid from current earnings despite an impaired capital[47] is the underlying thought. That this is a defect in construc-

41. *Hearings before Committee on Ways and Means, supra* note 6, at pp. 53, 137, 157, 177, 178 (d), 217, 738 (5), 805, 808 (12); Moley, *Tax Plan vs. The New Deal* (March 28, 1936) TODAY 12; H. R. REP. No. 2475, *supra* note 6, at pp. 19, 24. Senators Black and LaFollette feared that the increase of the flat rate of 3% upon corporations would strike a blow at the struggling corporations but did not have this same fear of the undistributed profits tax. SEN. REP. No. 2156, Part 2, *supra* note 16, at pp. 3 *et seq.* See also for a slight variation of this latter view, 80 Cong. Rec. 10683 (1936). For the views of the various newspapers on the Act see U. S. News, June 29, 1936, p. 10, cols. 1-4.

42. See *Hearings before Committee on Finance, supra* note 6, at p. 378.

43. See *Hearings before Committee on Ways and Means, supra* note 6, at p. 180.

44. Notes (1935) 21 VA. L. REV. 562, 44 YALE L. J. 1025; Breisch, *Avoiding Tax Problem by Reduction of Stated Capital*, Phila. Legal Intelligencer, Oct. 16, 1936, p. 4, col. 6.

45. A corporation may be in a position where it has issued all its authorized capital stock and would have to amend the charter in order to issue another share dividend. This may not be convenient if the corporate set-up is unwieldy so that the interests of the various shareholders conflict—some desiring share dividends, others more desirous of cash. Also, a corporation whose capital is impaired cannot issue stock dividends in most states.

46. *Hearings before Committee on Finance, supra* note 6, at pp. 293, 294; *Hearing before Committee on Ways and Means, supra* note 6, at p. 846.

47. It is elementary that states vary in the permission that they grant to corporations to pay dividends. See Weiner, *Theory of Anglo-American Dividend Law: American Statutes and Cases* (1929) 29 COL. L. REV. 461, 462. In some states corporations cannot declare dividends so long as their capital is impaired, or if this payment would impair their capital. *E. g.*, ILL. STAT. (Cahill, 1933) c. 32, ¶ 6; OHIO CODE (Throckmorton, 1934) § 8623-41; TENN. CODE ANN. (Michie, 1932) § 3722 (9). In others, the general incorporation laws provide that such

tion of the Act is obvious. However, as a matter of practicability it would seem easier for the states to adapt their laws to meet the conditions set up by a federal tax law, than for a federal tax act, governing businesses incorporated under forty-eight different sovereignties, to make allowances for the variations in the laws of the several states.

The conservative opposition to the new principle of taxation embodied in the present Act urged that the Act would compel the distribution of profits each year thus creating a situation in which corporations would not have sufficient reserves to carry them through unforeseen circumstances caused by extraordinary conditions of nature such as floods and fires or unusual economic crises.[48] Believing this to be an attempt to substitute governmental regulation for the judgment of the directors of the corporations, the opposition became even more irritated.[49] The latter assertion loses much of its force upon the realization that directors can declare taxable stock dividends and thus retain their surpluses as capital.

As to floods and fires, the answer is increased insurance.[50] The corporations will probably use the funds that they would ordinarily keep as reserves for unusual conditions, to purchase insurance. Already there is some indication that corporations, under the impetus given them by the new surtax,

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distributions cannot be made if the corporation is, or will thereby be rendered, insolvent. *E. g.*, MD. CODE ANN. (Bagby, 1924) Art. 23, § 38; MASS. GEN. LAWS (1932) c. 156, § 37; MO. REV. STAT. (1929) § 4569; N. H. PUB. LAWS (1926) c. 225, § 79. Still other combinations of these laws exist. *E. g.*, ARK. STAT. ANN. (Castle, Supp. 1931) § 1701y; ME. REV. STAT. (1930) c. 56, § 37. And in California and Delaware, corporations are permitted to distribute dividends despite an impaired capital, if the income is declared out of current earnings. CAL. CIV. CODE (Deering, 1931) § 346; DEL. CORP. LAW (1935) § 34 (b).

48. *Hearings before Committee on Ways and Means*, *supra* note 6, at p. 111; H. R. REP. No. 2475, *supra* note 6, at p. 19 (No. 1).

49. *Hearings before Committee on Ways and Means*, *supra* note 6, at pp. 284, 739 (9); H. R. REP. No. 2475, *supra* note 6, at p. 19 (5); *Social and Economic Experiments Under the Guise of Taxation*, Doc. No. 129 (July, 1936) AM. LIB. LEAGUE PAMPHLET 3, 6.

Hearings before Committee on Finance, *supra* note 6, at p. 415. "It would act either to bribe or coerce corporations into following a policy that would injure their credit. . . ." *Editorial*, N. Y. Times, May 4, 1936, p. 18, col. 1. Although most objectors argued that the Act will *compel* the issuance of dividends, there was one variation of the usual statement made during the hearings that is probably nearer correct for many instances, namely, that "The man who sits as a director of a corporation, and who has to determine how much to hold in the business, knows that he is going to make the stockholder happy if he gives him a little more money, and he knows that he is going to save taxes if he gives him a little more money, which will outweigh his sober judgment on all questions of policy as against the maintenance of the firm business structure, of the fundamental that he ought to be considering first, and it is there that this thing is particularly bad in its concept, it seems to me, as contrasted to taking just as much money by a straight tax that goes on every corporation alike, whether it chooses to keep the money in the business or to disburse it to the shareholder." *Hearings before Committee on Ways and Means*, *supra* note 6, at p. 322.

It would seem from the arguments of those opposed to the Act on this point that directors of our corporations have been managing their financial policies with respect to dividends very well in the past. However, W. H. Pouch, Chairman of the Industrial Loan Advisory Committee of the N. Y. Fed. Res. Bank states the following: "During past 18 months acting as chairman industrial loan advisory committee Federal Reserve Bank, second district, I have personally reviewed over 1,000 applications for loans from small and medium-sized companies and partnerships. I am firmly convinced the major cause for their unsound financial condition necessitating their demand upon Government for working capital was due to policy of paying dividends out of proportion to their earnings during years 1930, 1931, and 1932 thus depleting their liquid adequate working capital to meet their financial needs when increased volume of business was presented to them." *Hearings before Committee on Ways and Means*, *supra* note 6, at p. 210.

50. This may not be true for giant corporations, such as U. S. Steel. In the case of these associations, self-insurance in the nature of reserves is as socially sound as the purchase of insurance in an insurance company, which may be smaller than the corporation itself. In these cases there is a defect in the Act.

are spending their surplus profits for deductible items which at the same time constitute assets to the business.[51] As insurance is such an item, it is very probable that corporations will now increase their expenditures in that direction. Such a course seems socially desirable, for it is economically sound to have the insurance risks of disasters which affect a total community, such as floods or earthquakes, distributed over the entire nation so that the repercussion of the disaster will not affect a single community.

As to the point that the tax will not leave sufficient reserves to tide corporations through future depressions, the primary consideration, as stated by Herman Oliphant, General Counsel of the Treasury, is: "We have profited and can profit only by our past experience . . . that the greatest depression in the history of the country followed the accumulation of the greatest corporate surpluses in the history of the country."[52] In other words, the value of huge corporate surpluses is debatable, since they tend to be used in a manner not totally beneficial to society and as a result are often a direct cause of the depressions[53] they are purportedly designed to withstand.

Some have expressed the fear that the tax will tend to act as a prohibition against the repayment of existing debt inasmuch as the cost of repaying debts will be increased.[54] This picture is drawn: A corporation has a net income of $100,000 (normal tax net income). Upon this it must pay a normal tax of $13,840. This leaves an adjusted net income of $86,160. If the corporation desires to use approximately a third of this to retire a previous debt, not allowed as a deduction, it will distribute in dividends $60,000, retaining an undistributed net income of $26,160 upon which it must pay a surtax of $3,155. Factually this is true, but that corporations will stop paying debts is doubtful. Certainly our corporate businesses will not allow themselves to be thrown into bankruptcy for failure to pay their debts if they are at all able to meet them. If at the maturity of the obligation the corporation finds that it is impossible or unwise to repay the debt using its own funds, it may find it necessary, as a last resort, to borrow from Peter to pay Paul, with the net result that a substitution of creditors will take place, although there will be no decrease in the total amount of debt. But many corporations will be able to avail themselves of other means of paying their debts. For example, they may sell stock, distribute taxable stock dividends (using the capitalized surplus to pay the debts) or they may liquidate portions of their capital for the retirement of the debts. In any event, it is questionable whether the Act has prejudiced the position of the creditor class.

Some bankers objected to the Act because they said it would force them to curtail loans.[55] This argument assumes that corporations will hesitate in the

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51. That the Act has increased the amount that business is spending for advertising see Phila. Legal Intelligencer, Sept. 28, 1936, p. 1, col. 2.

52. *Hearings before Committee on Ways and Means*, *supra* note 6 at p. 640.

53. See FOSTER AND CATCHINGS, BUSINESS WITHOUT A BUYER (Pollak Foundation for Economic Research No. 10, 1927); Hunter, *The Taxation of Economic Surplus* (1935) 13 TAX MAG. 270, 271, advocates the high taxation of economic surplus for the purpose of preventing depressions. Altman, *Control of the Business Cycle by Means of the Income Tax* (1935) 13 TAX MAG. 9, states that much of the fluctuation of business can be averted by taxation which will prevent overaccumulation of savings.

54. *Hearings before the Committee on Ways and Means*, *supra* note 6, at p. 178; H. R. REP. No. 2475, *supra* note 6 at p. 19 (3); 80 CONG. REC. 10454 (1936); Moley, *Tax Plan v. the New Deal*, TODAY (March 28, 1936) 12.

55. *Hearings before Committee on Ways and Means*, *supra* note 6, at pp. 178 (f), 762; H. R. REP. No. 2475, *supra* note 6, at pp. 19 (7), 24. There were also variations of the same general argument expressed. See *Hearings before Committee on Ways and Means*, *supra*, at p. 761 (Act will disturb confidence of creditors of corporations and lead to general curtailment of credit and requirement of cash); ECONOMIC CONDITIONS (May, 1936) 72 (Act will increase uncertainty in the relationship between a bank and its corporate customers).

future to set up sinking funds or to make other provisions for the repayment of loans, inasmuch as money set aside for amortization purposes will be subjected to a high tax. It is probably true that the Act will have the effect of reducing the number of sinking fund clauses in future loan arrangements.[56] However, creditors will probably protect their position by wider use of installment repayment agreements. On the whole, although the Act may cause a change in the method of financing long term loans, it is debatable whether the change will be harmful; the likelihood is that in the long run the change will be neither materially better nor worse.

During the process of draftsmanship much discussion centered about the effect that the Act would have upon the formation and encouragement of monopolies. Those objecting to the bill argued that the increased pressure of a surtax would cause small corporations to distribute their earnings instead of using them for expansion.[57] If this premise is accepted, the conclusion is reached that such corporations will not grow, while large corporations which have surpluses and greater facilities for raising capital, will be able to increase their size. Furthermore, the large corporations will be aided by a lack of normal growth among the smaller corporations. The argument seems logically sound, but takes as its major premise the prediction that small corporations will remain static. There is no reason why this condition should be true. A small corporation under the Act is often in a much better position than a larger corporation to obtain capital for the purpose of expansion. The elasticity of the small corporation will enable it to issue taxable stock dividends and thus have the capitalized surplus available for expansion; its stockholders are usually in the lower individual income tax brackets, and therefore should be willing to receive the income, pay the tax, and reinvest in the corporation. On the other hand, a large corporation might, because of the unwieldy condition of its capital structure, be compelled to compete upon the open market for the investment of the dividends it had paid to its stockholders.

Interestingly enough, the proponents of the Act urged that it would discourage monopolies.[58] Their reasoning was that for many years our tax laws had aided and abetted the creation of monopolies. Wealthy stockholders, whose investments were usually in the larger corporations, chose not to withdraw their money, thus escaping the high individual surtaxes. With these assets the corporation bought out smaller competitors, and thereby extended its control over the sources of production and the markets. In short, the tax laws previous to the present Act encouraged the concentration of wealth which in turn was used for monopolistic purposes.

It is fairly clear, from an examination of the two arguments, that whether the taxation of corporate undistributed profits will result in the encouragement or discouragement of monopolies is unpredictable. Inasmuch as the growth of monopolies was not hindered by the previous revenue acts,[59] a fairly safe conclusion is that the new Act will at least do no more than leave the situation where it was formerly.

A strong economic argument against the Act was that it would accentuate the business cycle.[60] The basis of this argument lies in the assumption that

56. *The Financial Situation* (1936) 143 COMM. & FIN. CHRON. 1.

57. *Hearings before Committee on Ways and Means, supra* note 6, at pp. 178 (e), 297, 808 (16), 794-5; H. R. REP. No. 2475, *supra* note 6, at p. 19 (4).

58. Jackson, *The Proposed Revision of Corporation Taxes*, N. Y. Times, March 19, 1936, p. 21, col. 1.

59. See LAIDLER, CONCENTRATION OF CONTROL IN AMERICAN INDUSTRY (1931) c. 23; FETTER, THE MASQUERADE OF MONOPOLY (1931).

60. Moley, *Tax Plan vs. the New Deal* (March 28, 1936) TODAY 12; *Hearings before the Committee on Ways and Means, supra* note 6, at p. 211; H. R. REP. No. 2475, *supra* note 6 at p. 19; *Editorial*, N. Y. Times, May 4, 1936, p. 18, col. 1.

corporations will be forced to pay out dividends in times of large earnings and thus will have no surplus or reserves with which to continue dividends during times of depression. Consequently, the peak of prosperity will rise higher under the impetus of increased forced dividends, and the trough of depression will go much deeper because there will be no surplus from which dividends may be distributed. Opposed to this is the equally valid argument that the Act will aid in flattening the curves of the business cycle if it succeeds in forcing distributions of dividends during years of prosperity. The basis of this latter statement is, of course, the economic theory that savings tend to go into productive goods and if the policy of thrift is continued for too long a period the equilibrium between productive and consumptive goods is overthrown. The result is a lack of demand for the goods produced, the suspension of operation until the equilibrium is restored, with consequent idleness during the readjustment process. This inactivity in the long run is more wasteful than less thrift would have been.[61] Of course, a perfect balance is the ideal. Since many have argued that the former tax laws tended to encourage the accumulation of corporate surpluses to too great an extent, and others argued that the new Act will discourage corporate thrift, there is a possibility that the new Act may aid in attaining the happy medium. Moreover, the contention that the taxation of corporate undistributed profits will accentuate the business cycle presupposes a knowledge of the causation of the business cycle that does not exist. At present there are at least fifteen theories of the causes of business cycles, ranging from sun spots, held by the disciples of Professors Jevons and Beveridge of England, to rainfall, held by Professor Moore of Columbia University.[62] In fact, under some of the theories of business cycles, held by eminent authorities in the field of taxation, the undistributed profits tax should aid in smoothing out many of the mountains and valleys in our economic chart. Professor Hunter has said: "Recent events . . . seem to indicate that over-investment or over-expansion of equipment is an important contributing cause of our present industrial delirium. . . . Taxation of the surplus, then, may have the effect of smoothing out the severity of business fluctuations to the extent that over-investment or underconsumption is a cause of such fluctuations." [63]

The usual conflicts as to who will bear the burden of the tax arose, of course, in connection with the new Revenue Act. It was argued before the Finance Committee that the tax would be shifted to the consumer.[64] However, it is an elementary economic principle that a general tax upon net income cannot be shifted to the consumer,[65] although there is a sound argument that part of a tax upon the net income of a particular occupation may be.[66] The theory upon which this is based is that the producers subject to the tax will be at a disadvantage compared to producers in other lines of business, so that the capital invested in the former will tend to desert the field. The resulting diminution in supply will increase the price. The net effect is either a reduction in production in the field subject to the tax, or an increased price with the incidence of the tax falling upon the consumer. However, the present tax is not subject to that objection because it is sufficiently general in its application. Another possibility that the tax may be shifted to the consumers arises in the case of a

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61. See generally, Moulton, *Commercial Banking and Capital Formation* (1918) 26 J. Pol. Econ. 42; Foster and Catchings, *loc. cit. supra* note 53.

62. See Bye and Hewitt, Applied Economics (1930) 342 *et seq.*

63. *The Taxation of Economic Surplus* (1935) 13 Tax Mag. 270, 271.

64. *Hearings before Committee on Finance, supra* note 6, at p. 513.

65. Seligman, Shifting and Incidence of Taxation (1892) 167; Bye and Hewitt, *op. cit. supra* note 62, at 456.

66. Seligman, *op. cit. supra* note 65, at pp. 164-5.

monopoly that has not as yet reached a monopoly price.[67] Investigations of the problem have shown, as would be expected, that in most instances monopolies have kept their prices at the highest point consistent with the greater returns.[68] Assuming this to be true, there would seem to be very little likelihood that the tax will be shifted even here. There is also a view that if an income tax is laid exclusively upon a line of business which is carried on entirely by corporations, the tax may be passed on to the consumer.[69] This is on the theory that individual competition will be lacking as a result of which a general upward movement in price in the entire field will take place. However, if that were so, there is little doubt that individuals would come into the particular business and compete with the corporation. In brief, there is little foundation for the argument that the present tax will be shifted to consumers.

It has been asserted that the tax will be shifted to labor.[70] But most economists feel that a tax upon net income or economic surplus cannot be shifted but rather must lie where it falls.[71] Labor is a product subject to fluctuations just as is any other economic good. The price it brings, wages, is the highest amount it can summon in a competitive market under the influence of supply and demand. Inasmuch as the present tax is only upon corporations, it can readily be seen that should corporations attempt to lower wages, the probable result would be a migration of more efficient labor to businesses run by individuals. Corporate business, in order to compete for the most efficient labor, would be compelled to raise wages. It is probable also that labor in its present organized form would not tolerate any general reduction in wages, as would be necessary should the corporation seek in that way to pass on the undistributed profits tax.

The cry of double taxation has also been raised.[72] Those attempting to defeat the Act said that it would militate against the stockholders of a corporation which could not distribute its earnings as a result of which the earnings would be doubly taxed. The example cited was that of a corporation earning $100,000 in a year when for some reason or another it could not declare dividends. Therefore, the corporation would pay the normal tax and the surtax. The following year the corporation, finding itself in a position to liquidate this profit, would distribute it to the stockholders. Inasmuch as it now would be income in the hands of the stockholders it would be again subject to the income tax, both normal and surtax. Formerly, there was some relief for this in that the corporation paid only the normal tax, and when the dividends were paid out, the stockholder included them solely in his surtax returns. Although the factual basis of this argument is perfectly sound, whether it is objectionable is a matter of opinion. There is authority for the view that the corporation is for purposes of taxation a separate entity and should be taxed as such.[73] Secondly, the double taxation here rests primarily on the basis of ability to pay.[74] If a stock-

67. *Ibid;* see 1 TAUSSIG, PRINCIPLES OF ECONOMICS (1911) c. 12.

68. See JENKS AND CLARK, THE TRUST PROBLEM (1929) c. 7; JONES, THE TRUST PROBLEM IN THE UNITED STATES (1922) c. 11.

69. Seligman, *Can Income Taxes Be Shifted?* (1924) 2 NAT. INCOME TAX MAG. 101.

70. Professor Clyde L. King: "I have talked with a few folks who feel that this tax will be added to prices and be shifted to consumers. For the life of me I cannot see how that can be. For the burden of the tax is not the same on all competitors in the same industry. I think the tax in most instances will in part at least be absorbed by reducing the number of employees to a point where the total thus saved will about equal the tax. I feel convinced that others will pass the tax back to all wage-earners by reducing wages or by not increasing wages in proportion as prices rise. In either case the burden is shifted to labor, and will be kept on labor." Address under auspices of Penna. Econ. League delivered before Soc. for Advancement of Management, April 24, 1936.

71. See *supra* note 65.

72. *Hearings before Committee on Ways and Means, supra* note 6, at p. 809.

73. STUDENSKI, CHAPTERS ON PUBLIC FINANCE (1935) 577.

74. See Buehler, *The Principle of Expediency and Justice in Taxation* (1936) 21 BULL. NAT. TAX ASS'N 130, 131-2.

holder's income is so low that it is not within the income tax brackets, then his portion of the earnings is subject only to the normal tax and surtax of the corporation but is not taxed upon distribution. If a stockholder is in the middle brackets, upon distribution he pays another tax—but only a medium-sized one. If a stockholder is in the upper individual income brackets, then he is taxed to the hilt. Thus, this much can be said for the principle, that although double taxation is present, it does conform with the theory of ability to pay.

The exemption of corporations in bankruptcy and receivership brought forth the fear that many corporations would be tempted to go into bankruptcy in order to escape the undistributed profits tax.[75] However, the loss of prestige and injury to credit,[76] the decrease in value of the good will, the loss of control of the property which passes into the hands of the court,[77] the fees of receivers, attorneys, etc., will probably overcome any temptation to take advantage of that section. And should there still be a temptation, it should not be forgotten that there are many statutory restrictions imposed upon a corporation before it may enter the sanctuary of bankruptcy.

The capital goods industries presented the plea that much of their income must be used in order to buy new machinery and that this tax upon the use of such income for that purpose will raise the cost of new machinery to them to such an extent as to make the investment prohibitive.[78] This argument is very similar to the one that the tax will prevent industrial expansion because of lack of reinvested savings.[79] However, "The answer, of course, is that where there is a genuine opportunity for expansion, industry will get the capital as it always has—by issuing new stock, by floating bonds, by taking advantage of the present low interest rates and borrowing from the banks, or . . . [by use of surplus]. Capital has never been so plentiful or so cheap. The tax bill imposes no restriction on industrial expansion. It merely requires that the owner of capital pay his income tax before the money is invested. And it serves as a sorely needed protection against the accumulation of unused surpluses which was a primary cause of the depression." [80]

A final cry of discrimination was based on the ground that the new Act would place corporations selling on a cash basis, such as chain stores and mail order houses, in a more favorable position than those corporations compelled to sell on credit, the thought being that corporations engaged in cash transactions are able to distribute dividends more easily than creditor corporations, having an income on their books but not in their treasuries.[81] However, the latter corporations may place themselves on a par with the more liquid corporations by issuing some form of taxable stock dividend.[82]

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75. *Hearings before Committee on Ways and Means, supra* note 6, at pp. 594-5.

76. See 1 GERDES, CORPORATE REORGANIZATION (1936) § 48.

77. Note (1935) 84 U. OF PA. L. REV. 992.

78. *Hearings before Committee on Finance, supra* note 6, at pp. 500, 509.

79. Thompson, *Governor Landon Versus Senator Robinson*, N. Y. Herald-Tribune, Sept. 3, 1936, p. 19, cols. 7, 8; H. R. REP. No. 2475, *supra* note 6, at p. 23.

80. *A Reply to Dorothy Thompson* (Sept. 12, 1936) NATION 292, 293.

81. *Hearings before Committee on Ways and Means, supra* note 6, at p. 808 (7).

82. In addition to the many arguments and objections aired in the various hearings and debates there is an obvious defect in the administrative provisions of the Act which is not inherent in the principle of taxing undistributed corporate income. The surtax is imposed upon the undistributed net income of each taxable year and for a corporation to obtain a dividends paid credit, the dividend must actually be received by the shareholder within the taxable year. U. S. Treas. Reg. 4674, Art. 27-1 (b). This means that a corporation must calculate, before knowing the amount of its net income for any given year, the amount of dividends that it will distribute. And if a corporation underestimates that net income, and thereby issues a smaller amount of dividends than it would have issued had it known before-

Constitutionality

There has been some doubt raised as to the constitutionality of the Act.[83] The General Counsel for the Treasury has stated that, in his opinion, the Act is constitutional;[84] there have also been statements to the contrary.[85] An analysis of the question involves a discussion of the purposes and effects of the Act.

One of the purposes of the Act, although generally stated indirectly, and certainly one of the effects of the Act, is to compel corporations to distribute a portion of their earnings and profits each year.[86] On this basis there were many statements that Congress was attempting to regulate the distribution of corporate earnings. It is well settled that Congress may regulate by taxation, provided the subject matter is within the constitutional powers of Congress to control.[87] How-

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hand what its net income was going to be, its surtax will be correspondingly higher. There is some relief found in the dividend carry over provisions [§ 27 (b)] whereby a corporation may secure credit in a later year for an amount of dividends paid in a prior year in excess of the amount required to obtain full advantage of the dividends paid credit section.

Another perennial argument that was raised as an objection to the Act was that it will drive capital out of productive enterprise and into the field of tax exempt securities. See H. R. REP. No. 2475, *supra* note 6, at pp. 19 (8), 26; *Hearings before Committee on Finance, supra* note 6, at p. 94. This contention is by no means novel and merits no new discussion. See HARDY, TAX-EXEMPT SECURITIES AND THE SURTAX (Publication of the Institute of Economics, 1926); *Taxation and Tax-Exempt Income,* SEN. DOC. No. 148, 68th Cong., 1st Sess. (1924) (Rep. of Fed. Trade Comm.). For a discussion of this problem relating to the present Act see *Hearings before Committee on Ways and Means, supra* note 6, at pp. 583 *et seq.*

83. C. C. H. Fed. Tax Serv. Special Revenue Bull. (May 13, 1936): "There are opinions, however, that the Bill is vulnerable constitutionally on the theory of the *Hoosac Mills* AAA case. View is that purpose of Bill is to control corporation policies—a subject not within legislative power of Congress." See 80 CONG. REC. 6319, 6183 (1936). Phila. Legal Intelligencer, Aug. 6, 1936 p. 1, col. 2: "Against the background of preparation for imposition of the tax appeared the likelihood that constitutional challenge of the new levy will be made in the courts . . . ."

84. *Hearings before Committee on Ways and Means, supra* note 6, at p. 621.

85. See *supra* note 83.

86. One of the purposes stated is to "prevent avoidance of surtax by individuals through the accumulation of income by corporations." H. R. REP. No. 2475, *supra* note 6, at p. 3. Senator Black: "What you are seeking to bring out here is, as I understand it . . . . If there were small stockholders in the corporation . . . who only owned a very small block of stock, who would not have had to pay 15 per cent. on their normal individual income, it was to their interest to have that money distributed, and so they were injured if the corporation held it and did not pay it out." *Hearings before Finance Committee, supra* note 6, at p. 21. "Because by the control being exercised by a small group, as we know it is exercised in every large corporation in America, and sometimes only three men might pass on 100,000 stockholders' rights, under that system that has been operating, that group that controls the large number of stockholders can withhold the stock and pay a 15 per cent tax even on the profit of the very small investor, while the larger investor might escape the 50 per cent. tax which other unfortunate citizens would pay who did not happen to be in terested in that corporation by owning a large block of stock?" *Id.* at 54. Compare statement of Senator Barkley: "It is not the concern of this bill to squeeze money out of the corporation treasury into the hands of stockholders, but it is the purpose of this bill that, whether it is squeezed or not, it shall pay a tax." *Id.* at 53. Also statement of Chairman Doughton: "There is no intention or desire whatever to interfere with the internal managemen of business enterprises. The object of this revenue measure is not to tell corporate management what proportion of earnings they shall distribute and what proportion they shall retain. The object is rather to see that, whatever the decision of corporate managements, the Federal Government shall not be unreasonably and inequitably deprived of necessary revenue and that the tax burden is equitably distributed." 80 CONG. REC. 6175 (1936).

87. "One indirect means that has often been used for the control of our social and economic life is taxation. The use of taxation for that purpose, where it is only secondary to that of raising revenue, has long been held to be within the taxing power of Congress." Altman, *Control of the Business Cycle by Means of the Income Tax* (1935) 13 TAX MAG. 9, 10. Veazie Bank v. Fenno, 8 Wall. 533 (U. S. 1870); Legis. (1935) 24 GEO. L. J. 122.

ever, many of the corporations subject to taxation under the Act would probably be regarded, for most purposes, as engaged in intrastate commerce, and thus not subject to regulation by Congress under its ordinary powers.[88] The argument runs to the effect that Congress is attempting to use the taxing power to regulate the financial policies of corporations—a subject which it could not directly regulate. The Supreme Court has permitted Congress, on certain occasions, to tax in a manner equivalent to regulation that which is not subject to regulation under the delegated powers of Congress[89]; on other occasions the Court has forbidden it.[90] The test used by the Court would seem to be twofold: (1) Is there an absence of rules and regulations concerning a subject foreign to the stated objective of gaining revenue?[91] (2) Is the Act on its face a revenue measure?[92]

Although it may be doubtful whether a tax act would be held constitutional if it met only one of these questions,[93] yet it seems clear that if an affirmative answer can be given to both the Act would be held constitutional. The present Act falls in the second category for there is no rule or regulation in the Act that does not directly pertain to the acquisition of revenue, and none of the sections governs distributions of income except for the purpose of measuring the tax. And certainly the Act is on its face a revenue measure.[94] Unless one realizes the probable effects and implications of the Act, it is doubtful whether he would regard it as a measure intended to force corporations to distribute their earnings.

In order to have its constitutionality sustained, the Act would have to be distinguished from the statute held invalid in the *Child Labor* case.[95] In that case, however, the Court laid stress on many criteria that are not present in the Revenue Act of 1936. There were many regulations not concerned with the raising of revenue. The Act on its face was an attempt to regulate child labor. Furthermore, there were two provisions in the Child Labor Act that were indigenous to that Act alone and would almost be sufficient in themselves to differentiate the present tax Act from the Child Labor Act: (1) the Child Labor Act provided for many duties which were to fall upon the Secretary of Labor—a provision obviously not for the purpose of raising revenue. In the Revenue Act the administration is in the hands of the Commissioner of Internal Revenue. (2) The Child Labor Act provided that in the event of *non-scienter,*

88. Especially would this be true since the limitations placed on the meaning of interstate commerce by the Supreme Court in the *Schechter* case, 295 U. S. 495 (1935).

89. McCray v. United States, 195 U. S. 27 (1904), upholding the oleomargarine tax, 32 STAT. 193 (1902), 26 U. S. C. A. § 971 (1935); United States v. Doremus, 249 U. S. 86 (1919), upholding the HARRISON NARCOTIC DRUG ACT. 38 STAT. 785 (1914), 26 U. S. C. A. § 1040 (1935); *cf.* Linder v. United States, 268 U. S. 5 (1925).

90. Bailey v. Drexel Furniture Co., 259 U. S. 20 (1922), holding unconstitutional the child labor tax, 40 STAT. 1138 (1919); Hill v. Wallace, 259 U. S. 44 (1922), holding unconstitutional the GRAIN FUTURE TRADING ACT. 42 STAT. 187 (1921). A recent decision by the Supreme Court on this point is United States v. Constantine, 296 U. S. 297 (1935) 84 U. OF PA. L. REV. 663 (1936). The same general point came up again when the constitutionality of the NATIONAL FIREARMS ACT [48 STAT. 1236 (1934), 26 U. S. C. A. § 1132a (1935)] was raised in United States v. Adams, 11 F. Supp. 216 (S. D. Fla. 1935). This Act provided that anyone dealing commercially with firearms must pay a license tax and also levied a tax of $200 upon the transfer of firearms. Judge Ritter upheld the tax on the theory that it is a revenue measure on its face. See generally, Cushman, *Social and Economic Control Through Federal Taxation* (1934) 18 MINN. L. REV. 757; Powell, *Child Labor, Congress, and the Constitution* (1922) 1 N. C. L. REV. 61.

91. Powell, *supra* note 90.

92. See Cushman, *supra* note 90 at 774.

93. (1928) 41 HARV. L. REV. 533 suggests a third test.

94. The Act is supposed to raise $805,000,000 in revenue. N. Y. Times, June 21, 1936, § 1, p. 1, col. 8, p. 31, col. 5.

95. 259 U. S. 20 (1922).

i. e., if an employer did not know that the person employed was below the age of sixteen, the penalizing tax did not apply. The present Act does no such thing. If the corporation does not realize that it is withholding its income (perhaps through faulty accounting) it is, nonetheless, subject to the full tax.

What Constitutes a Taxable Share Dividend

Admittedly one of the effects of the Act will be to force the corporations to distribute their annual income in a manner permitting the government to tax that income in the hands of the shareholders, many of whom are presumably within the higher income brackets.[96] The compelling force is the surtax on undistributed income. Before this Act there was little pressure on corporations to distribute their earnings; the new surtax creates or at least greatly enlarges that force. And yet corporations will desire to retain as much of their earnings for expansion purposes as they did in the past. This will present management with the problem of how to keep the earnings and at the same time avoid payment of the surtax. This can be done only by the issuance of taxable stock dividends, which will effectuate the government plan of taxing the individuals within the higher brackets on income[97] which, were it not for the surtax, would be left in the corporation immune to taxation as a part of the individual's income.[98] In the past, corporations had no incentive to issue dividends taxable in the hands of the shareholders, and the pressure of the wealthy persons controlling or influential in the management of the corporation tended towards the issuance of non-taxable dividends. There is now, however, because of the high corporate surtax, a definite incentive for declaring dividends taxable in the hands of the stockholder. If a corporation with a normal-tax net income of $1,000,000 does not distribute cash or other taxable dividends, the corporation pays a total tax of $323,327.79, whereas, if the total adjusted net income is distributed in cash or stock dividends taxable in the hands of the shareholders, the tax will be only the normal tax, or $148,840. In the face of such heavy taxation, it seems that the predictions of tremendously increasing dividend payments[99] will be realized in the future.

As to what will constitute a taxable dividend, if other than cash is distributed, there was considerable doubt until the recent case of *Koshland v. Helvering.*[100] And although that case has clarified the issues to a considerable extent, there still remain many situations upon which the Supreme Court has not yet ruled.

Eisner v. Macomber[101] is the classical stock dividend case. There, the Supreme Court held that a common shareholder who received a stock dividend of common shares realized no income but had merely received two pieces of

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96. See *Hearings before Committee on Ways and Means, supra* note 6 at pp. 25 *et seq.*

97. There is a possibility that corporations made up of parent and susbidiary associations may utilize the section exempting corporations in bankruptcy to avoid the surtax. Section 14 (d) (2) states that "corporations which for any portion of the taxable year are in bankruptcy under the laws of the United States, or are insolvent and in receivership in any court of the United States or of any State, Territory, or the District of Columbia" are exempt from the surtax. If the directors in charge of the corporate setup can put the parent corporation into bankruptcy for any portion of a year, and then during that year have the subsidiary companies pour their earnings into the parent in the form of dividends, that setup may avoid the tax. However, see *supra* p. 97 for the objections to any procedure involving bankruptcy of a corporation.

98. Eisner v. Macomber, 252 U. S. 189 (1920). It is this requirement of realization which today prevents the use of a tax system based wholly on the disregard of the corporate entity. See *supra* note 17.

99. Seidman, *Securities and the New Tax Law* (June 29, 1936) BARON'S 3; U. S. News, June 29, 1936, p. 14, col. 1; TIME (Oct. 19, 1936) 80.

100. 56 Sup. Ct. 767 (1936). For the facts of this case see page 124 of this REVIEW.

101. 252 U. S. 189 (1920).

paper which did not change his proportionate interest in the corporation. A second ground of the Court's holding, disregarded by later decisions,[102] was that for a shareholder to receive income there had to be a separation of something from the corporate assets—an "outgo".[103] If the latter test had been stringently applied, many of the Court's later opinions in the reorganization cases would have perforce held otherwise.[104] *Eisner v. Macomber* was heralded far and wide as "the stock dividend case".[105] It was natural, therefore, especially in view of the very broad language used by the majority opinion, for lawyers and laymen to assume that all stock dividends were not subject to a direct tax. Treasury regulations were immediately promulgated following the decision stipulating that stock dividends were to be exempted from income taxation.[106] No distinction was made as to what stock dividends were to be exempted—the regulations were broad and seemingly excluded all as a subject of taxation. The Act of 1921,[107] and all acts thereafter, until the present one, contained provisions that "a stock dividend shall not be subject to tax".[108] The Supreme Court in *Koshland v. Helvering*,[109] holding that common shares awarded as a stock dividend to holders of preferred shares constituted income because the shareholders' interest in the corporation was proportionately different after the stock dividend than before, said that it had for a long time attempted to inform everyone that the case of *Eisner v. Macomber* was to be limited strictly to its

102. Koshland v. Helvering, 56 Sup. Ct. 767 (1936), and see cases cited *infra* note 104.

103. 252 U. S. at 207.

104. In United States v. Phellis, 257 U. S. 156 (1921), each shareholder of New Jersey corporation received two shares of common stock of the newly-created Delaware corporation for each common share of the New Jersey corporation, without surrendering the original share. The total assets of the New Jersey corporation were transferred to the Delaware corporation. In Rockefeller v. United States, 257 U. S. 176 (1921), an oil and gas corporation split into two separate corporations, the original one involved in the production of oil, the other in the pipe line business. The assets necessary to the latter corporation were transferred to it in exchange for its capital stock, which stock was distributed pro rata to the shareholders of the original corporation. In Cullinan v. Walker, 262 U. S. 134 (1923), a Texas oil corporation dissolved, and its trustees in liquidation organized two other Texas corporations (dividing the business as in Rockefeller v. United States). To each of these corporatons was transferred the assets paid for by stock and bonds of the two newly formed corporations. A holding company in Delaware was then created which took all the stock of the Texas companies as payment for the stock of the Delaware corporation. The Delaware stock and the bonds of the two new Texas corporations were then distributed to the shareholders of the original company which was then dissolved. In Marr v. United States, 268 U. S. 536 (1925), a common and preferred (7%) shareholder in a New Jersey corporation received from a Delaware corporation organized by the officers of the New Jersey corporation, to which all the assets of the earlier corporation were transferred, five new common shares in exchange for one old common share and one and one-third new preferred shares (6%) of Delaware stock for each preferred share of the subsequently dissolved New Jersey corporation. In all four of these cases the Court found that the shareholder had received income in the form of share dividends—yet in no one of these cases was there, substantively speaking, any segregation of the assets of the corporation. There was no "outgo" other than the transfer of the assets, or part of the assets, from one company to another company substantially identical in composition and business purpose. The original corporation, looking behind the mere formal transfer, still existed with all its original assets.

105. Note, for example, the titles of some of the articles commenting on *Eisner v. Macomber* appearing while the case was pending, or immediately after the decision: Seligman, *Are Stock Dividends Income?* (1919) 9 AM. ECON. REV. 517; Powell, *Stock Dividends, Direct Taxes and the Sixteenth Amendment* (1920) 20 COL. L. REV. 536; Warren, *Taxability of Stock Dividends as Income* (1920) 33 HARV. L. REV. 885; Clark, *Eisner v. Macomber and Some Income Tax Problems* (1920) 29 YALE L. J. 735.

106. U. S. Treas. Reg. 65, Art. 1547.

107. 42 STAT. 227, 228 (1921).

108. 43 STAT. 254 (1924); 44 STAT. 10 (1926); 45 STAT. 822 (1928); 47 STAT. 204 (1934).

109. 56 Sup. Ct. 767 (1936).

facts.[110] It is true that during the past sixteen years there had been built up among the lower courts as well as in the Supreme Court, a strong series of cases in which stock dividends of various sorts were held to be income.[111] Even before the decision of the *Macomber* case, the Supreme Court in *Peabody v. Eisner*[112] had held, that where Corporation *A* distributed to its shareholders shares in Corporation *B*, the full value of the *B* shares were taxable to the shareholder of *A* Corporation receiving them. But such a dividend has not been regarded as a "true stock dividend" and the latter term, or the shorter form "stock dividend", has been restricted to mean at least shares in the distributing corporation.[113]

It was in the field of corporation reorganizations, however, that the Court undertook in detail the problem of defining and redefining "income" as the term applied to stock dividends. Gradually the *Macomber* case was limited in application, but Congress and the Treasury failed to utilize the taxing possibilities thus opened by the Court. Within a period of four years, from 1921 to 1925,

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110. *Id.* at 769.

111. Some of the cases since *Eisner v. Macomber* holding stock dividends taxable: Vogt Machine Co. v. United States, 39 F. (2d) 986 (Ct. Cl. 1930), *cert. denied*, 282 U. S. 861 (1930) (dividend declared in cash, setting up a credit which was to be payable in stock in six and twelve months thereafter, but against which account shareholder could draw in cash); Comm'r v. Tillotson Mfg. Co., 76 F. (2d) 189 (C. C. A. 6th, 1935) (accrued dividends of preferred stock paid in common stock of the corporation); Eugene E. Paul, 2 B. T. A. 150 (1925) (cash dividend declared; six days later new stock issue was authorized, and stockholders agreed that dividend check would be used to purchase the newly issued common and preferred stock); W. J. Hunt, 5 B. T. A. 356 (1926) (prior to declaration of cash dividends, stockholders agreed among themselves to apply check toward purchase of previously issued stock); Luthe Hardware Co., 6 B. T. A. 53 (1927) (declaration of cash dividend followed by increase in capital stock and majority shareholders who had not yet received cash were paid off in stock); Margaret V. Payne, 19 B. T. A. 1305 (1932) (cash dividend was declared and checks were issued, but there was an agreement among stockholders that this dividend was to be used for the purchase of new issue of stock); Joseph Paper, 29 B. T. A. 523 (1933) (declaration gave the stockholders option to take dividends in cash or in preferred stock); L. Elmer Wood, 29 B. T. A. 735 (1934) (declaration of cash dividend, giving preferred shareholders the right to receive the dividend in cash or at their option to purchase new peferred shares); United States v. Phellis, 257 U. S. 156 (1921); Rockefeller v. United States, 257 U. S. 176 (1921); Cullinan v. Walker, 262 U. S. 134 (1923); Marr v. United States, 268 U. S. 536 (1925); William C. Huntoon, 14 B. T. A. 459 (1928) (stock dividend declared and shareholder turned it back immediately to the corporation to get indebtedness cancelled).

112. 247 U. S. 347 (1918).

113. Thus even U. S. Treas. Reg. 86, Art. 115-8 provided that "The issuance of *its own* stock by a corporation as a dividend to its shareholders does not result in taxable income to such shareholders." (Italics supplied.)

That this provision may not have meant what it seems expressly to say is indicated by the decisions of the Board of Tax Appeals in *Koshland v. Helvering* and *Comm'r v. Tillotson* and the Sixth Circuit Court of Appeals in *Comm'r v. Tillotson*. It was held that not only were the stock dividends in those cases income, but also taxable under the 1932 Act which contained the statement: "A stock dividend shall not be subject to tax." This rather absurd result followed from the circular reasoning employed: The statutory exemption of stock dividends was the direct result of the *Eisner v. Macomber* decision (which is incontrovertible); therefore, the provision was meant to apply only to those dividends which under the *Macomber* case were not income. Since the dividends in these cases did constitute income, the statutory exemption has no application. In the face of the constant Congressional hunt for new fields of taxation one can fully appreciate the difficulty the Board of Tax Appeals and one circuit court of appeals had in believing that Congress meant not to tax something it constitutionally could. But that does not justify a complete disregard of the wording of the Act. The only logical view would seem to be that expressed in the majority opinion of the *Koshland* case: "Although Eisner v. Macomber affected only the taxation of dividends declared in the same stock as that presently held by the taxpayer, the Treasury gave the decision a broader interpretation which Congress followed in the Act of 1921."

five cases arose,[114] all of which, though presenting varying factual differences, were alike in that they involved the question as to whether the shares given by the new company either in exchange for or in addition to the shares of the old company constituted income in the hands of the shareholder to the amount that the fair market value of the substituted or additional shares exceeded the cost of the original shares. In all but one [115] of these cases the Court found that the new and the old corporations were essentially different, so that the new shares represented interests quite different from those evidenced by the first shares. Such a finding met the first test of the *Macomber* decision, that of "different proportionate interest". But clearly the corporation gave none of its assets to the shareholder, a fact which would seem to be a requisite of the "separation" test, if that test were required. In the other case,[116] which was the fourth in point of time, the Court found such a similarity between the new and the old corporations that each shareholder's proportionate interest remained the same after reorganization as before—thus falling squarely within the limits of the *Macomber* case, and therefore resulting in no income to the shareholder.

Thus far, the Supreme Court, faced with only four situations concerning the stock dividend question, has decided: (1) common shares awarded as a dividend to common shareholders do not constitute income [117]; but (2) shares of Corporation *B* issued as a dividend to shareholders of Corporation *A*,[118] (3) shares of a reorganized corporation (meeting the Court's test of being separate and distinct from the old corporation) distributed to the shareholders of the old corporation in exchange for or in addition to the shares already owned,[119] and (4) common shares issued as dividends to holders of preferred shares,[120] are all income to the shareholders. There still exist, however, many problems which have not as yet been adjudicated by the Court.[121] As to these, the only guides for corporations desiring to take advantage of Section 27 of the present Act by distributing stock dividends taxable in the hands of the shareholders in order to reduce the corporate surtax are the Treasury Regulations [122] dealing with this phase of the law. The Regulations cover some but not all of the situations and, as would be expected, answer most of the debatable issues in a manner generally favorable to the government. Inasmuch as the new Act makes considerations as to dividends of prime importance, an analysis of the unadjudicated problems is appropriate.

Although Justice Brandeis in his dissent in the *Macomber* case confidently assumed that the issuance of preferred shares would always constitute taxable

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114. United States v. Phellis, 257 U. S. 156 (1921); Rockefeller v. United States, 257 U. S. 176 (1921); Cullinan v. Walker, 262 U. S. 134 (1923); Weiss v. Stearn, 265 U. S. 242 (1924); Marr v. United States, 268 U. S. 536 (1925).

115. Weiss v. Stearn, 265 U. S. 242 (1924).

116. *Ibid.*

117. Eisner v. Macomber, 252 U. S. 189 (1920).

118. Peabody v. Eisner, 247 U. S. 347 (1918).

119. See *supra* note 114.

120. Koshland v. Helvering, 56 Sup. Ct. 767 (1936).

121. As for example, whether any or all of the following will constitute the receipt of taxable income: (1) the addition of voting rights (2) preferred share dividends issued to either preferred or common shareholders (3) treasury shares (4) stock rights to one class of shares distributed to another class (5) common shares chosen by a common shareholder as a result of an option to select cash or common shares.

122. Thus, under U. S. Treas. Reg. 4674, Art. 115-3, preferred stock issued as a share dividend to common shareholders is taxable (which view appears to be sound); Art. 115-4 states that where there is an option to take cash or stock, the receipt of stock constitutes income (which also would seem sound); Art. 27-3 apparently decides that treasury shares are taxable as income, since it provides for a dividend credit equal to the fair market value, or to the adjusted basis of the stock in the hands of the corporation.

income,[123] there is no case law on the subject. Logic, however, would seem to sustain this unsupported statement.[124] A preferred share gives to its holder a right, prior to that of the common shareholders, to a certain proportion of dividends as represented either by a given percentage of the face value or amount in dollars designated as the preference. Therefore, every time a dividend of preferred stock is awarded to holders of either common shares or preferred shares, these shareholders now have either a new right or a greater right (depending on whether they held common shares or preferred shares before the dividend) to the first dividends paid by the corporation. Thus, assuming that *A* holds one common share, and *B* one preferred share in *X* Corporation, each of $100 par value, and there is declared a share dividend of one preferred share for each share whether common or preferred, *A* now has a right to a portion of any dividends declared whereas before he had no right to any dividends until the preferred shareholders first received the amount of their preference; concurrently, *B* has a right to more dividends before the common shares participate in any distribution than he had before the dividend payment. Therefore, the proportionate interests of both *A* and *B* in the corporation are different after the distribution than before, and under the sole remaining test of *Eisner v. Macomber,* iterated by the Court in *Koshland v. Helvering,*[125] those preferred shares, representing that new interest, are income. Where the preferred shares are cumulative, *A* will, of course, be building up a credit that he otherwise would not get (assuming that no dividends are distributed), and *B* will be getting a much larger credit than he would have received had there been no dividend distribution. In a jurisdiction, such as New Jersey,[126] which applies the dividend credit theory, a somewhat strange result arises in one situation. This is where *A* and *B* each have one share of $100 par value, *A*'s share being common and *B*'s preferred at six per cent, and there is a dividend declaration of one preferred share each to *A* and *B*. As long as the distributed earnings after the dividend amount to less than $9 per original share of common stock, the dividend credit of *A* will be greater than it would have been had no share dividend been declared. If, however, the earnings are exactly $9, then *A* will have neither gained nor lost by the stock dividend; but if the earnings are more than $9, *A*'s credit will be less than it would have been had no share dividend been declared. Of course, if the dividend had been given solely to *A*, then under no circumstances would he be in a less favorable position, under the dividend credit theory, after the share dividend than before.[127]

123. 252 U. S. at 229.

124. See Magill, *Realization of Income Through Corporate Distributions* (1936) 36 Col. L. Rev. 519, 536.

125. 56 Sup. Ct. 767 (1936). The Court in its opinion did not allude to the segregation test.

126. Day v. United States Cast Iron Pipe & Foundry Co., 95 N. J. Eq. 389, 123 Atl. 546 (1924), *aff'd,* 96 N. J. Eq. 736, 126 Atl. 302 (1924); Elkins v. Camden & Atl. R. R., 36 N. J. Eq. 668, 70 Atl. 929 (1908), *aff'd,* 75 N. J. Eq. 539, 73 Atl. 514 (1909). See Lattin, *Is Non-Cumulative Preferred Stock in Fact Preferred?* (1930) 25 Ill. L. Rev. 121. The term "dividend credit theory" is applied to describe the theory under which there arises each year a "credit" in favor of the various shareholders in the corporation to the extent that each shareholder would have received dividends had the entire earnings available for dividends that year been distributed. Of course, if all the earnings of a corporation are distributed in the form of dividends, or if there are no earnings, no "dividend credit" would arise.

127. Section 112 (b) (2) of the present Act says that "No gain or loss shall be recognized . . . if preferred stock in a corporation is exchanged solely for preferred stock in the same corporation." This provision has been present in the Revenue Acts since 1921, and were it not for the present Act which makes it desirable for the corporation to issue taxable stock dividends rather than non-taxable ones, this provision would make it simple for a corporation to issue what should constitute a taxable dividend of preferred shares to

Section 27 (c) of the Act provides: "If a dividend is paid in property other than money (including stock of the corporation if held by the corporation as an investment) . . . [there shall be a] . . . dividends paid credit . . .".[128] Section 27 (h) declares that "If any part of a distribution (including stock dividends and stock rights) is not a taxable dividend in the hands of . . . shareholders . . ., no dividends paid credit shall be allowed with respect to that part." If, therefore, a dividend of treasury shares is not income, then despite the provision in 27 (c) the corporation will not be allowed dividend credit. Justice Brandeis in his dissent in the *Macomber* decision stated that he had no doubt that such a distribution would constitute income.[129] As authority for that proposition he cited two early cases, one from Connecticut[130] and the other from Massachusetts,[131] both of these cases presenting the question as to who, between the life-tenant and the remainderman, should receive such dividends and deciding that they should go to the life-tenant. There are decisions opposed to this view.[132] In consideration of the fact that the legal attributes of a "treasury share" are similar to those of an authorized but unissued share[133] (for example, neither can be voted or receive dividends) and that the legal relations between a corporation and shareholder are the same whether the shares issued as a share dividend were treasury shares or newly created shares, it is difficult to sustain in logic any distinction in their treatment for tax purposes. Take, for example, the exact *Eisner v. Macomber* situation. Assume that there are five shareholders, each holding one common share. Lying in the corporate treasury (if such a picture can be conceived) are five common shares that were formerly issued but which have been returned to the corporation. These five common shares are then divided equally among the shareholders. Has the proportionate interest of any shareholders here changed one whit more than in *Eisner v. Macomber*? The conclusion would therefore seem to follow that treasury shares should be treated as all others and, when distributed as dividends, should constitute income to the same extent.

Since the taxable stock dividend offers so many means for corporations to retain their earnings and profits, while at the same time avoiding the corporate surtax, it will be rarely that a corporation will reorganize in order to

holders of preferred shares without any tax on the recipient, by the mere device of having the holder of the shares exchange them for a greater number of preferred shares. But no such case arose before the 1936 Act and probably will not arise now, inasmuch as the interest of the corporation at present lies in issuing taxable stock dividends, and therefore, will gain nothing by taking advantage of this section—in fact, to do so would only react to the corporation's detriment.

128. Section 27 (c) treats treasury shares distributed as dividends differently from other taxable share distributions by providing that ". . . the dividends paid credit . . . shall be the adjusted basis of the property in the hands of the corporation at the time of the payment, or the fair market value of the property at the time of the payment, whichever is the lower."

129. 252 U. S. at 228.

130. Green v. Bissell, 79 Conn. 547 (1907).

131. Leland v. Hayden, 102 Mass. 542 (1869).

132. The cases are collected in Note (1923) 24 A. L. R. 76.

133. Drinker, *The Pre-emptive Right of Shareholders to Subscribe to New Share* (1930) 45 HARV. L. REV. 586, 603, n. 45: "There is some loose talk in the cases about a corporation owning its shares. . . . A corporation cannot, of course, own its own shares, as an asset, any more than a man can swallow his own oesophagus. When a corporation acquires its own shares, what happens is that a part of the co-proprietors buy out one of their former associates. When they do this with the intention of presently substituting a new associate, the corporation carries the shares, at cost, as an asset, with the fiction that they are outstanding, although they are really but a book entry and not recognized for voting purposes or in connection with such practical problems as income taxation." For the view that treasury shares are taxable see Winsor, *The Possibility of Taxing Dividends Paid in Treasury Stock* (1921) 2 NAT. INCOME TAX MAG. 328.

avoid the surtax.[134] But occasionally a reorganization may be made necessary either through court order or business exigency. If in the reorganization the shares of the new corporation are awarded to the shareholders of the original corporation, without exchange of the old shares for the new, the Act does not govern the situation; but it would seem that if that which the shareholders receive meets the test of a taxable stock dividend, the shareholder should be taxed as on the receipt of income. If, however, in the reorganization the shareholders surrender their shares in exchange for new shares, then despite the fact that the total market value of all their shares is equal to or greater than the market value of the combined old and new shares in the preceding situation, no gain or loss is recognized. Under the latter facts the corporation would, therefore, receive no dividends paid credit since the shareholders had been given no income taxable under the Act.

The corporate reorganization cases, long a favorite theme upon which writers dwelled in discussing the nature of income, are reduced from practical importance to historical interest. Throughout the years they indicated a trend which found its natural culmination in *Koshland v. Helvering*. With a basic misconception cleared by the holding of the Court in its latest opinion [135] on the subject, the fears of many that the taxing power of the government had been greatly crippled by the decision by *Eisner v. Macomber* have been allayed.

One more situation merits discussion. If a corporation declares a cash dividend with an option to the recipient thereof to purchase stock, and the option is exercised, it is clear that the shareholder has received income; his exercise of the option has no effect on the preceding receipt of income. The situation becomes more complicated where the corporation gives to the shareholders their choice of either stock or cash. In fact, under the 1934 Treasury Regulations [136] the shareholder, if he chose to receive his dividend in a form of stock dividends ordinarily non-taxable, was held to have received no income, although there was authority in the Board of Tax Appeals to the contrary.[137] The 1936 Treasury Regulations have resolved the doubt in favor of the view adopted by the Board of Tax Appeals and now provide that if the shareholder has the right to an election between cash and stock and chooses the shares, the share dividend is realized income even though it would not have been so considered had there been no alternative offer of cash.[138] Under the regulation, this would be so even if all the shareholders accepted stock. This problem has never been raised before the Supreme Court, but it is probable that the Court would sustain at least the theory behind the regulation, though, as will be pointed out, it might find fault with a few of its details.

When a corporation declares in the alternative a dividend in stock or cash, with the choice in the shareholder, since there is an obligation running from the corporation to its shareholders which the corporation may have to satisfy entirely by cash, the result is similar to the situation in which a corporation declares a flat cash dividend with the option in the shareholder to purchase stock. In both instances, the corporation and the shareholders have the same rights and liabilities. It would seem, therefore, that the same result should follow. The test used by the English courts, as one authority [139] has pointed out,

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134. Before the present Act there was much discussion as to the avoidance of taxes through corporate reorganizations. See BAAR AND MORRIS, HIDDEN TAXES IN CORPORATE REORGANIZATIONS (1935) 441.
135. 56 Sup. Ct. 767 (1936).
136. G. C. M. 6709, VIII-2 CUM. BULL. 132 (1929).
137. L. Elmer Wood, 29 B. T. A. 735 (1934).
138. U. S. Treas. Reg. 4674, Art. 115-4.
139. Magill, *supra* note 124, at 535.

has been: Was the choice offered to the shareholder such a one that economically there actually existed an alternative? Thus, if the fair market value of the share was much higher than the cash equivalent offered, the court would find that what actually had been intended was a stock dividend. Such a test might well be followed by the American courts, for if the courts would enforce strictly the wording of the Treasury Regulation, *Eisner v. Macomber* would very easily be overridden. Any corporation seeking to declare a dividend of common shares to common shareholders merely would have to make the dividend declaration in the form of an election of cash or shares, with the cash offered far below the fair market value of the shares. In addition, in order reasonably to assure an actual election, it is suggested that the courts take into consideration the cash balance, liquid investments, and corporate history of the corporation, for if a corporation with a very small cash balance and frozen assets declares a dividend in the alternative, it is likely that it intended the dividend to take the form of shares and not cash. Of course, corporations will sometimes borrow in order to pay dividends, and this in no way reflects upon its financial stability. A study of the corporate history would help in a situation where the corporation had in the past frequently declared such dividends and only about thirty or forty per cent of its shareholders had accepted cash. In such a case, it might well be that although the corporation had a small cash balance, it would be sufficient to pay the usual demand for cash dividends—and in fact, the corporation might have intended this to be a cash dividend for those desiring it. But a further difficulty is caused by the statement in the Treasury Regulations that even if the election by the shareholders is exercised or exercisable before the dividend declaration, the corporate distribution is taxable.[140] It is not readily conceivable how a shareholder may have a real election if there has been as yet no dividend declaration. Until then, the shareholder has no right to any money or shares. Any election he makes must come after that declaration. If, before there is any corporate declaration, the shareholders band together and decide that they all, or a substantial majority of them, will take shares of stock, it would seem that the following "option" offered by the dividend declaration is but a fiction, and one through which the court should look.[141] Especially would this be so if at the same time the corporation had practically no cash or liquid investments available.[142] And since the courts have done this, even where the subsequent declaration was entirely in the form of cash plus an option to purchase shares,[143] they should *a fortiori* reach the same result here. If that is done, and the factual situation presented is similar to that of *Eisner v. Macomber,* that which the shareholder receives is not income. On this basis, the broad terms of the Treasury Regulation may very likely be held invalid.

In brief, it is clear that many forms of stock dividends may be utilized by a corporation which desires to retain its earnings and avoid the surtax. In order to succeed, the corporation must avoid those distributions which do not, under the holdings of the Supreme Court, constitute income to the shareholder. But the restrictions now imposed are few. Corporations need not fear that their days of

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140. U. S. Treas. Reg. 4674, Art. 115-4 (2).

141. See Irving v. United States, 44 F. (2d) 246 (Ct. Cl. 1930).

142. George T. Smith, 21 B. T. A. 782 (1930); Irving v. United States, 44 F. (2d) 246 (Ct. Cl. 1930); United States v. Mellon, 281 Fed. 645 (C. C. A. 3d, 1922). Such a declaration, obviously would be an attempt by the corporation to distribute a dividend, ordinarily tax-free, in such a manner as to subject it to the individual's income tax in order that the corporation obtain a dividend credit.

143. United States v. Davison, 1 F. (2d) 465 (W. D. Pa. 1924), *aff'd,* 9 F. (2d) 1022 (C. C. A. 3d, 1926), *cert. denied,* 271 U. S. 670 (1926).

expansion are in the past. Had *Koshland v. Helvering*[144] been decided other than it was, they might have been hampered by the limited field within which their stock dividends would be held taxable to the shareholder. As it is, no resourceful corporation, wide-awake to the necessary implications of that decision, will suffer through the new surtax feature of the Act; the result, in the main, will be greater taxes levied upon those who best can afford them.

D. C. and A. B. G.

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144. The Supreme Court's decision in *Koshland v. Helvering* rounds out a judicial definition as regards income. Income is the receipt by a shareholder of a new right, which changes his proportionate interest in the corporation, other than the right that the corporation debit the surplus account and credit the capital account. *Cf.* Note (1932) 45 HARV. L. REV. 1072 in which the writer contends that the Supreme Court has abandoned an attempt at a definitive concept of income. The definition presented above is descriptive if not definitive. There need be no gain (see Magill, *supra* note 124 at 532), or severance of the assets from the corporation (see *supra* note 102). The following, in addition to those already presented, on a basis of the definition suggested, should be held to be income: (1) Stock rights granting to the shareholder something he did not have before. See MAGILL, TAXABLE INCOME (1936) 49, 50. (2) Bonds. See Doerschuck v. United States, 274 Fed. 739 (E. D. N. Y. 1921); United States v. Fuller, 42 F. (2d) 471 (E. D. Pa. 1930). (3) Scrip, notes, etc., giving the shareholder now a creditor's rights against the corporation, where prior thereto he had only an owner's rights. (5) Rights to participate in dividends beyond the preference of preferred shareholders, or to cumulative dividends theretofore non-cumulative. In all of these cases the element of realization is still present, for all of these interests, in order that they may constitute income, must be acquired.